No. 11064

In the United States Circuit Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

MADELEINE N. SHARP, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE PETITIONER

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CITATIONS

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OPINION BELOW

The opinion of the Tax Court of the United States (R. 29–38) may be found in 3 T. C. 1062.

JURISDICTION

The petition for review involves a deficiency of $750 in gift taxes for the year 1938. The taxpayer filed her gift tax return for the year 1938 with the Collector of Internal Revenue for the Second Collection District of New York. (R. 41.) On January 12, 1942, the Commissioner mailed a statutory notice of deficiency to the taxpayer. (R. 6–9.) On April 6, 1942, the taxpayer filed a petition with the Tax Court for redetermination of her gift tax liability, pursuant to Section 1012 of the Internal Revenue Code. (R. 3–5.) The final order and decision of the Tax Court, deciding that

there was no deficiency in gift tax was entered on August 22, 1942. (R. 39.) It has been stipulated (R. 40) by the parties that the decision of the Tax Court may be reviewed by the Circuit Court of Appeals for the Ninth Circuit and the petition for review was filed November 9, 1944 (R. 41–45), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

QUESTION PRESENTED

Whether a gift in trust for the taxpayer's minor son was a gift of "future interests in property" and hence not within the $5,000 exclusion provision of Section 504 (b) of the Revenue Act of 1932.

STATUTE AND REGULATIONS INVOLVED

Revenue Act of 1932, c. 209, 47 Stat. 169:

> SEC. 502. COMPUTATION OF TAX.
>
> The tax for each calendar year shall be an amount equal to the excess of—
>
> (1) a tax, computed in accordance with the Rate Schedule hereinafter set forth, on the aggregate sum of the net gifts for such calendar years, over
>
> (2) a tax, computed in accordance with the Rate Schedule, on the aggregate sum of the net gifts for each of the preceding calendar years.
>
> * * * * *
>
> SEC. 504. NET GIFTS.
>
> (a) *General Definition.*—The term "net gifts" means the total amount of gifts made during the calendar year, less the deductions provided in section 505.
>
> (b) *Gifts Less Than $5,000.*—In the case of gifts (other than of future interests in prop-

erty) made to any person by the donor during the calendar year, the first $5,000 of such gifts to such person shall not, for the purposes of subsection (a), be included in the total amount of gifts made during such year.

Treasury Regulations 79 (1936 ed.):

> ART. 11. *Future interests in property.*—No part of the value of a gift of a future interest may be excluded in determining the total amount of gifts made during the calendar year. "Future intersts" is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time. * * *

STATEMENT

The relevant facts as stipulated (R. 10–11), as amended (R. 27–28), and as found by the Tax Court are as follows:

On September 20, 1938, Madeleine N. Sharp created a trust for the benefit of her son, Donald Nichols Sharp, naming the Title Guarantee and Trust Company as trustee. (R. 10.) On the same date she transferred to the trustee cash and securities having a fair market value of $252,090.79. Donald Nichols Sharp was born on September 9, 1922, and was 16 years of age on September 20, 1938, the date on which the trust agreement was executed. (R. 11.)

On September 20, 1938, the present value of the right to receive the income from the trust established

on that date was in excess of $5,000. (R. 11.) The trust instrument provided in parts as follows (R. 12–13):

> Article First: A. To hold, manage, invest, and reinvest said trust estate, and to collect and receive the rents, interest, income and dividends (hereinafter referred to as income) therefrom and after paying the proper charges against the same, to apply and pay over to the use and for the benefit of my son Donald Nichols Sharp the net income therefrom during his minority, and upon his reaching his majority to pay the net income to my said son Donald Nichols Sharp during his life. The Trustee may make any payment of any income thus applicable to the use of my son Donald Nichols Sharp, during his minority, by paying the same to his mother, or guardian of his property, or other person or corporation designated by the Donor (without obligation to look to the proper application thereof by the person receiving it) or by expending it in such manner as the Trustee, in its discretion, believes will benefit my son. Any balance of income shall be accumulated until the arrival of my son, Donald Nichols Sharp at majority, at which time the Trustee shall pay over the said accumulated income to my son Donald Nichols Sharp.

It was further provided that the trust was to terminate at the death of the son with provisions for distributions of principal to his children. (R. 13.)

In determining the taxpayer's gift tax for the year 1938 the Commissioner disallowed a $5,000 exclusion from taxpayer's net gifts for that year on the ground

that the gift in trust to her son was a gift of a future interest. (R. 35.)

STATEMENT OF POINTS TO BE URGED

The Commissioner's assignments of error, all of which are here relied upon, appear in the record at pages 43–45. They may be summarized by the simple statement that the Tax Court erred in holding the gift in question was a gift of a present interest which entitled the taxpayer to an exclusion of $5,000 in computing her gift tax liability for the year 1938.

SUMMARY OF ARGUMENT

A reasonable construction of the trust instrument involved requires the legal conclusion that the income from the trust was a gift of a future interest to the donor's minor son. The decision below rests upon the ground that the specific direction to the trustee to accumulate any balance of income during the son's minority was "purely precautionary and constituted no limitations upon the trustee to apply and pay over the net income to the son," during his minority. As shown by other language in the trust instrument this conclusion is erroneous. Only so much of the income as was applicable to the use of the son was to be applied or paid over, and there is no showing in the record as to what this amount may be. Also it is specifically provided that the accumulated surplus shall be paid over to the son upon his reaching his majority. Thus it is evident that the use, possession or enjoyment of some portion of the income may be postponed, and under the terms of the statute the taxpayer is not entitled to the exclusion claimed.

ARGUMENT

The gift in trust for the benefit of a minor beneficiary was a gift of a future interest as to which no exclusion was allowable in computing taxpayer's gift tax for the year 1938

Section 504 (b) of the Revenue Act of 1932, *supra,* excludes from a taxpayer's net gifts the first $5,000 of gifts (other than of future interests in property) made to any person during the taxable year. The taxpayer here claims an exclusion of $5,000 for the year 1938 with respect to the gift made in trust to her son in that year. If, as the Commissioner contends, the gift to her son was one of a future interest, the taxpayer is not entitled to the exclusion.

Treasury Regulations 79, Article 11, *supra,* defines future interests as follows:

> "Future interests" is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession, or enjoyment at some future date or time.

As recently stated in *Commissioner* v. *Disston* (Sup. Ct.), decided June 4, 1945 (C. C. H. Inheritance, Estate & Gift Tax Service, par. 10,207), this definition has been approved repeatedly. *United States* v. *Pelzer,* 312 U. S. 399; *United States* v. *Ryerson,* 312 U. S. 260; *Fondren* v. *Commissioner,* 324 U. S. 18.

The precise question here is whether, under the terms of the trust instrument, there is a possibility that the beneficiary's use, possession or enjoyment of any part of the income may be postponed. *Commis-*

sioner v. *Taylor,* 122 F. 2d 714, (C. C. A. 3rd) certiorari denied, 314 U. S. 699.[1] It is the Commissioner's contention that "Article First" of that instrument specifically provides for some measure of future use or enjoyment. After first directing (R. 12) that the trustee "apply and pay over to the use and for the benefit of my son Donald Nichols Sharp the net income therefrom during his minority" it is provided (R. 13):

> *Any balance of income shall be accumulated until the arrival of my son Donald Nichols Sharp at majority, at which time the Trustee shall pay over the said accumulated income to my son Donald Nichols Sharp.* [Italics supplied.]

The basis of the Tax Court's decision that the gift was one of a present interest in the trust income, was that the donor imposed the duty on the trustee to apply and pay over the entire net income to the son during his minority. In reaching this conclusion it was necessary for the Tax Court to also conclude (R. 37) that the provision for accumulating any balance of income was "purely precautionary and constituted no limitation upon the trustee to apply and pay over the net income to the son." We submit that there is no reasonable basis for wholly disregarding the provision for the accumulation of income for the

[1] Although the Third Circuit Court of Appeals specifically overruled the *Taylor* decision in *Disston* v. *Commissioner*, 144 F. 2d 115, 119, the Supreme Court cited it with approval in *Fondren* v. *Commissioner*, *supra* (p. 21), and by implication approved it in reversing the Circuit Court's decision in the *Disston* case.

minor beneficiary. A cardinal rule of construction of a trust instrument is that the intent of the settlor as evinced by the language of the instrument must prevail and that intent must be collected from the whole instrument taken together.

In the *Disston* case, *supra,* the first direction of each trust was to accumulate the net income until the minor reached 21. The Supreme Court observed:

> If that were all, it would again be clear that a future interest was created by the postponement of enjoyment. A later paragraph directs the trustees however, "to apply * * * such income therefrom as may be necessary for the education, comfort and support of the respective minors," and to accumulate the remainder.

In the instant case, the first direction of the trust is to apply and pay over the income for the use and benefit of the son during his minority. It that were all, it might well be that a present interest was created. It appears to be settled that if income of a trust is required to be distributed periodically, as annually, the gift of the income is one of a present interest. See *Fondren* v. *Commissioner, supra.* However, such is not the case. The same paragraph then specifically provides for the accumulation of the balance of the income which is not applicable to the use of the minor.

In providing the manner in which the trustee may make payments of income during the son's minority the payments are described (R. 13) as "any payment *of any income thus applicable to the use of my son.*" [Italics supplied.] Certainly this sentence suggests that some part of the income may not be applicable

to the use of the minor and when coupled with the next succeeding sentence, which positively directs accumulation of *any balance,* it is clear that the intent of the donor was to distinguish between income which was applicable to the use and for the benefit of the son during his minority and that income which should be held until he reached majority.

It should be noted that the words "use and benefit" are employed only with respect to the son's minority. In contrast to the provision regarding minority it is simply stated (R. 12–13) "and upon his reaching his majority to pay the net income to my said son Donald Nichol Sharp during his life." When coupled with other provisions of that paragraph it seems clear that the words "use and benefit" were used as words of limitation.[2] It is immaterial for tax purposes that the exact administration of that limitation is not expressed. The fact that a balance of income was con-

[2] In the Tax Court the taxpayer cited the case of *Gasquet* v. *Pollock*, 1 App. Div. 512 (N. Y.), 37 N. Y. S. 357, affirmed, 158 N. Y. 734, 53 N. E. 1125, as holding that where a trust instrument directed the income to be applied to the use of the beneficiary, with no discretion given the trustees, the beneficiary was entitled to have the entire income paid over as it accrued. However, in that case, the instrument made no provision whatever for accumulating any income and the court particularly observed that fact. The case is therefore no authority in the instant case. On the other hand, it has been held that where a testamentary trustee was directed to apply and pay the income for the education of minor beneficiaries, there was a clear implication that the trustee should reserve any surplus income over and above the money to be expended for the limited purpose fixed by the testatrix, although there was no mention whatever, in the instrument, of accumulating any income. *In re King's Estate*, 121 Misc. 298 (N. Y.), 200 N. Y. S. 829.

templated and that the trustee was directed to accumulate it is sufficient.

There is no indication from the face of the trust instrument or the surrounding circumstances that a steady flow of some ascertainable portion of income to the minor would be required for his use and benefit. The existence of a duty to apply the income for the minor's use and benefit gives no more clue to the amount that will be *applicable* for that purpose, than did the duty to apply income necessary for the education, comfort and support of the minors in the *Disston* case, *supra.* Taxpayer is entitled to no presumption that the entire income from a $250,000 fund will be needed and therefore become applicable to the use and benefit of the taxpayer's minor son. Whether or not a court of equity might intervene does not meet the question. In cases where the instrument specifically states that payment or withholding of income rests in the full discretion of the trustee, a court of equity may intervene. *Welch* v. *Paine,* 130 F. 2d 990 (C. C. A. 1st); *Commissioner* v. *Brandegee,* 123 F. 2d 58 (C. C. A. 1st); *French* v. *Commissioner,* 138 F. 2d 254 (C. C. A. 8th). In fact, in cases where a minor has insufficient means of support and education, a court of equity may no doubt intervene even though the trustee has no power to apply any income to the use of the minor. See *Matter of Wagner,* 81 App. Div. 163 (N. Y.), 80 N. Y. S. 785; *Matter of Howland,* 37 Misc. 114 (N. Y.), 74 N. Y. S. 950, reversed on other grounds, 75 App. Div. 207 (N. Y.), 77 N. Y. S. 1025.

There is nothing in this record to indicate that the parents of the minor beneficiary were unable or unwilling to support and educate their child and we believe that this would have to be shown before a court of equity would compel the trustee to apply or pay over an amount which it had in good faith accumulated as a *balance* above that for the reasonable use and benefit of the minor.

The Tax Court stated (R. 38) that it found support for its conclusion, that this gift was one of a present interest, in *Commissioner* v. *Lowden,* 131 F. 2d 127 (C. C. A. 7th), and *Fisher* v. *Commissioner,* 45 B. T. A. 958, appealed on another issue, 132 F. 2d 383 (C. C. A. 9th). We do not think either of those cases offer such support because in each there were two vital facts which are absent in the instant case. In each, the net income was directed to be distributed *annually.* In neither was there any mention of accumulation of any part of the income. Also, in *Smith* v. *Commissioner,* 131 F. 2d 254 (C. C. A. 8th), upon which the Tax Court also relied, the trust instrument made no specific provision for accumulation of income or possible postponement of its enjoyment by the beneficiary, but the Eighth Circuit held that the dominant purpose of the settlor, as gathered from the whole instrument, repelled the idea of accumulation or postponement. The validity of this premise is doubtful and was criticized by this Court in *Fisher* v. *Commissioner, supra* (p. 386) as resting on "an insecure foundation, being based, as it is, on the court's view of the purpose of the settlor." Also, in *Welch* v.

Paine, supra, this same theory was criticized (p. 992) as causing—

> uncertainty and confusion, depending as it would upon a weighing of the relative emphasis placed by the settlor on accumulation and current distribution in defining the trustee's discretionary power.

Nor do we think any support for the decision below may be found either in *Commissioner* v. *Kempner,* 126 F. 2d 853 (C. C. A. 5th), or in *Commissioner* v. *Brandegee, supra.* In the former, the gift in trust was of non-interest bearing notes of third persons, payable in the future. The court held that the mere fact that the notes were not by their terms payable until a future time did not make them gifts of future interests. In the *Brandegee* case, the trustees were given discretionary power to pay off any mortgages, either from the principal or the income of the trust, before paying any income to the beneficiaries. In remanding the case for a determination of whether there were any mortgages outstanding at the date of the gift in trust, the court merely stated (p. 62) that "in ordinary usage a life tenant under a trust, having the right to the immediate beneficial enjoyment of the income, is considered as having a present interest." We find nothing in that language to support the decision below because it assumes, as the answer, the very issue in this case.

The fact that all of the income *might* be applied or paid to the beneficiary currently is not sufficient to make the beneficiary's interest a present one. Unless

it is proved that all of the income or some reasonably certain portion thereof would be paid or applied currently the difficulty of valuing the present interest arises. See H. Rep. No. 708, 72nd Cong., 1st Sess., p. 29 (1939–1 Cum. Bull. (Part 2) 457).

We submit that this taxpayer has failed to prove the facts which would entitle her to the exclusion which Congress has granted for certain types of gifts only. *New Colonial Co.* v. *Helvering,* 292 U. S. 435. The purpose of the exclusion is simply to avoid the burden of recording and reporting numerous small gifts, which would be disproportionate to the revenue produced. The amount [3] of the exclusion is made sufficiently large to cover most gifts such as wedding and Christmas gifts. (H. Rep. No. 708, *supra.*)

The least that may be said of this trust instrument is that it might be interpreted as providing conflicting directions to the trustee but there is no legal basis for ignoring one or the other in order to prove that the interest in question is an interest with respect to which the exclusion is allowable, particularly since the record discloses none of the circumstances under which the gifts were made. See *Fondren* v. *Commissioner, supra,* (pp. 21–22).

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[3] The amount of the exclusion was reduced to $4,000 in the Revenue Act of 1938, c. 289, 52 Stat. 447, Section 505, before it reduction to $3,000 in the Revenue Act of 1942, c. 619, 56 Stat. 798, Section 454 (26 U. S. C. 1940 ed., Supp. IV, Sec. 1003). The report of the House Committee relating to the latter act indicates that the exclusion would be abolished completely except for the administrative difficulties which would arise if that were done. H. Rep. No. 2333, 77th Cong., 2d Sess., p. 37 (1942–2 Cum. Bull. 372).

CONCLUSION

The Tax Court erred in holding that the taxpayer is entitled to the exclusion claimed. Its decision should be reversed.

Respectfully submitted,

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